

PETRO-REEF RESOURCES LTD.

1997

ANNUAL REPORT

REPORT TO THE SHAREHOLDERS

During the 1997 fiscal year the Company drilled and/or completed four wells as part of a six well program at Morinville Alberta for a 100% success ratio. The Company is presently tying in two of these wells. They should be on stream at the end of March, 1998 together with the third well which went on production in November, 1997. Cumulative production from the three wells should be three to four million cubic feet of natural gas per day. The Company's net working interest averages twenty-two percent for a net flow rate of 660 to 880 thousand cubic feet of gas per day. Two additional wells are standing as capped gas wells waiting for remedial workovers to be done after break-up. The sixth gas well is to be drilled and placed on stream with these two workover wells by September 30, 1998.

In February of 1998 the Company drilled the first well of a multi-well farmout program on a 2,560 acre multiple oil and gas zone prospect in the Peavey Area of Alberta. This exploration well was drilled to a depth of 1,274 meters to test the Devonian reef section and was completed with production pipe set to total depth. Two potential oil reservoirs were identified by logs and drill-stem tests. The Company will proceed in the near future to production test this well and will follow up with additional wells if the production test is successful. The Company has an interest varying from 16.25% to 19.50% in this prospect.

In addition to the foregoing the Company participated in a well, in January 1998, on another prospect at Morinville West which was drilled and completed with production pipe run to total depth. This well is currently awaiting completion as a natural gas well. Petro-Reef has a 9.0% gross-overriding royalty convertible to a 30.0% working interest after payout in this 640 acre prospect.

The Company continues to concentrate its efforts in Central Alberta where multi-zone potential, for oil and gas, and existing infrastructure of plants and pipelines make early cash flow possible. The core area of operations which initially consisted of the Morinville Area north of Edmonton has been expanded, by geological and geophysical mapping, to include much of Central Alberta. Several dozen high grade, multi-zone, prospects have been identified. The Company plans to pursue these prospects through an aggressive property acquisition program. To accomplish this acquisition program the Company has entered into an Agreement with another industry participant whereby Petro-Reef shall pay one hundred percent (100%) of the cost of identifying the prospects and lands for acquisition and the Participant shall purchase said prospects and lands together with Petro-Reef. Petro-Reef shall recover its exploration overhead and seismic costs as a working interest in the properties on an equalization basis. Petro-Reef's working interest in each property will be based on the total cost expended by Petro-Reef, including exploration overhead, seismic, and land costs divided by the total cost expended by Petro-Reef and the industry participant.

Gross revenues increased for fiscal year 1997 to \$59,600 versus \$44,209 for 1996 and expenses were \$164,502 for 1997 versus \$113,083 for 1996. Most of the increase in expenses were due to a \$50,000 bonus payment to management and a one-time \$21,000 legal cost. Net loss per common share for 1997 was \$0.01 which is unchanged from 1996.

Natural gas prices have remained consistent over most of 1997 and the first part of 1998. Oil prices have retreated from \$26.00 U.S. to \$14.00 U.S. The Company believes that the mid to long term price of oil and natural gas will be much higher than it is today based on the long term supply and demand picture in North America and the rest of the world.

As a result of the foregoing the Company anticipates a significant increase in cash flow per share and net asset value in the near future.

On December 22, 1997 the Company added a member to its board of directors for a total of six. The new board member is Mr. John Lagadin who was president of Direct Energy Gas Marketing until its sale in 1997. Mr. Lagadin was also the person who conceptualized and started the Alliance Pipeline and was a co-owner of same until recently when his interest was sold. The addition of Mr. Lagadin adds the marketing expertise that was needed at the board level.

On behalf of the Company and its board of directors I would like to thank the shareholders for their continued support. We will endeavour to meet and hopefully exceed your expectations with a significant increase in cash flow per share and a higher share price for the Company in the near future.

T. M. Donhuysen
President and C.E.O.
Petro-Reef Resources Ltd.

March 20, 1998

**PETRO-REEF RESOURCES LTD.
CORPORATION INFORMATION**

Directors and Officers

Theodore M. Donhuysen

Chief Executive Officer

President & Director

Calgary, Alberta

Joseph Werner

Chairman of the Board

Chief Financial Officer & Director

Calgary, Alberta

Gary W. Coleman

Director

Calgary, Alberta

Robert N. Maertens-Poole

Director

Calgary, Alberta

Douglas W. Schneider

Director

Calgary, Alberta

John Lagadin

Director

Calgary, Alberta

Head Office

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Facsimile: (403) 264-1348

Legal Counsel and Corporate

Secretary

R. Greg Powers

Bank

Hong Kong Bank of Canada

Auditors

Coopers & Lybrand

Registrar & Transfer Agent

The CIBC Mellon Trust Company

Calgary, Alberta

Stock Listing

The Alberta Stock Exchange

Symbol "PER"

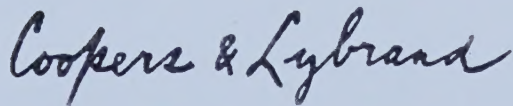
Auditors' Report

To the Shareholders of Petro-Reef Resources Ltd.

We have audited the balance sheets of Petro-Reef Resources Ltd. as at December 31, 1997 and 1996 and the statements of loss and deficit and changes in financial position for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at December 31, 1997 and 1996 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.



Chartered Accountants
Calgary, Alberta
February 13, 1998

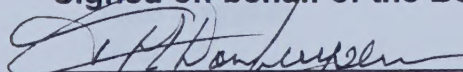
Petro-Reef Resources Ltd.

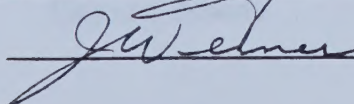
Balance Sheets as at December 31, 1997 and 1996

	1997 \$	1996 \$
Assets		
Current assets		
Cash and short-term investments	171,402	63,673
Accounts receivable	80,039	16,679
Prepaid expenses and deposits	11,029	10,968
	<u>262,470</u>	<u>91,320</u>
Property, plant and equipment (note 2)	<u>679,091</u>	<u>610,962</u>
	<u><u>941,561</u></u>	<u><u>702,282</u></u>
Liabilities		
Current liabilities		
Accounts payable and accrued charges	187,215	8,197
Future site restoration	1,099	936
	<u>188,314</u>	<u>9,133</u>
Shareholders' Equity		
Share capital (note 3)	2,326,599	2,161,599
Deficit	<u>(1,573,352)</u>	<u>(1,468,450)</u>
	<u>753,247</u>	<u>693,149</u>
	<u><u>941,561</u></u>	<u><u>702,282</u></u>

The accompanying notes are integral to the financial statements.

Signed on behalf of the Board,

 _____, Director

 _____, Director

Petro-Reef Resources Ltd.

Statements of Loss and Deficit

For the years ended December 31, 1997 and 1996

	1997 \$	1996 \$
Revenue		
Oil and gas sales	59,635	45,679
Royalties, net of Alberta Royalty Tax Credits	<u>(4,915)</u>	<u>(5,523)</u>
	54,720	40,156
Other revenue	<u>4,880</u>	<u>4,053</u>
	<u>59,600</u>	<u>44,209</u>
Expenses		
Production	25,568	29,456
General and administrative	111,286	57,693
Depletion, depreciation and amortization	<u>27,648</u>	<u>25,934</u>
	<u>164,502</u>	<u>113,083</u>
Net loss for the year	(104,902)	(68,874)
Deficit – Beginning of year	<u>(1,468,450)</u>	<u>(1,399,576)</u>
Deficit – End of year	<u>(1,573,352)</u>	<u>(1,468,450)</u>
Basic and fully diluted loss per common share	<u>(0.01)</u>	<u>(0.01)</u>

The accompanying notes are integral to the financial statements.

Petro-Reef Resources Ltd.

Statements of Changes in Financial Position
For the years ended December 31, 1997 and 1996

	1997 \$	1996 \$
Operating activities		
Net loss for the year	(104,902)	(68,874)
Items not affecting working capital – Depletion, depreciation and amortization	<u>27,648</u>	<u>25,934</u>
	(77,254)	(42,940)
Net change in non-cash working capital items	<u>115,597</u>	<u>(26,820)</u>
	<u>38,343</u>	<u>(69,760)</u>
Financing activities		
Issuance of common shares	165,000	120,000
Share issuance costs	<u>–</u>	<u>(967)</u>
	<u>165,000</u>	<u>119,033</u>
Investing activities		
Disposals of property, plant and equipment	–	4,938
Expenditures on property, plant and equipment	<u>(95,614)</u>	<u>–</u>
	<u>(95,614)</u>	<u>4,938</u>
Change in cash and short-term investments during the year	107,729	54,211
Cash and short-term investments – Beginning of year	<u>63,673</u>	<u>9,462</u>
Cash and short-term investments – End of year	<u><u>171,402</u></u>	<u><u>63,673</u></u>

The accompanying notes are integral to the financial statements.

Petro-Reef Resources Ltd.

Notes to Financial Statements

For the years ended December 31, 1997 and 1996

1. Accounting policies

Oil and gas operations

The company is engaged in the exploration for and production of oil and natural gas in Canada.

The company follows the full cost method of accounting for oil and gas operations whereby all costs related to the acquisition of, exploration for and development of oil and gas reserves are capitalized. Such costs include leasehold acquisition costs, geological and geophysical costs, lease rentals, drilling, plant and equipment costs and related overhead. Government incentives are credited to the cost of the oil and gas properties at the time the expenditures are incurred. Proceeds from the disposal of properties are applied as a reduction of the cost of the remaining assets with no gain or loss recognized, unless such a sale would result in a change of more than twenty percent in the depletion rate.

In applying the full cost method, the company calculates a cost ceiling which restricts the capitalized costs less accumulated depletion from exceeding the estimated future net revenue from proved reserves, determined by independent reservoir engineers, based on year-end prices and production costs plus the net cost of undeveloped acreage, less future general and administrative expenses, financing costs, site restoration costs and income taxes.

Depletion is computed using the unit-of-production method based on gross estimated proved oil and gas reserves (converted to equivalent units on the basis of estimated relative energy content). In determining the appropriate depletion rate, the company considers the net book value of its proved oil and gas properties, as well as the estimated future costs to be incurred in developing proved reserves and the cost of undeveloped acreage.

Estimated costs of future abandonment and restoration of well sites and associated facilities are amortized over the life of the properties on a unit-of-production basis.

Depreciation

Depreciation of furniture and fixtures is calculated using the declining balance method at an annual rate of 20%.

Income taxes

The company follows the tax allocation method of accounting for income taxes whereby the income tax provision for the year is based on the income reported in the accounts. Under this method, the company provides for deferred income taxes as a result of claiming deductions for income tax purposes in excess of amounts claimed for financial statement purposes.

Earnings per share

Earnings per common share are calculated using the weighted average number of common shares outstanding during the year of 12,111,494 (1996 - 11,387,327). Fully diluted earnings per share are calculated on the basis of the weighted average number of shares that would have been outstanding during the year had all stock options and warrants been exercised at the date of their issuance.

Petro-Reef Resources Ltd.

Notes to Financial Statements

For the years ended December 31, 1997 and 1996

1. Accounting policies (cont'd)

Joint ventures

Substantially all of the company's activities are conducted jointly with other industry partners and accordingly, these financial statements reflect only the company's proportionate interest in such activities.

Measurement uncertainty

The amounts recorded for depletion and depreciation of property, plant and equipment and the provision for site restoration costs are based on estimates. The ceiling test is based on estimates of proved reserves, production rates, natural gas prices, future costs and other relevant assumptions. By their nature these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

2. Property, plant and equipment

	1997		
	Cost \$	Accumulated depletion and depreciation \$	Net \$
Petroleum and natural gas properties	1,945,758	1,272,920	672,838
Furniture and fixtures	13,538	7,285	6,253
	<u>1,959,296</u>	<u>1,280,205</u>	<u>679,091</u>
	1996		
	Cost \$	Accumulated depletion and depreciation \$	Net \$
Petroleum and natural gas properties	1,852,869	1,246,998	605,871
Furniture and fixtures	10,813	5,722	5,091
	<u>1,863,682</u>	<u>1,252,720</u>	<u>610,962</u>

No interest or general and administrative expenses were capitalized during the period.

Unproven property costs of \$107,022 (1996 - \$96,988) have been excluded from capitalized costs subject to depletion.

Petro-Reef Resources Ltd.

Notes to Financial Statements

For the years ended December 31, 1997 and 1996

3. Share capital

The authorized share capital of the company is comprised of an unlimited number of preferred shares and an unlimited number of common shares. Details of the changes in the company's share capital during 1997 and 1996 are as follows:

	1997		1996	
	Number of shares	Amount \$	Number of shares	Amount \$
Common shares				
Balance – Beginning of period	11,571,494	2,171,599	11,231,494	2,042,566
Issued pursuant to stock options being exercised	600,000	155,000	100,000	10,000
Issued pursuant to warrants being exercised	–	–	240,000	120,000
Issuance costs	–	–	–	(967)
Balance – End of period	<u>12,171,494</u>	<u>2,326,599</u>	11,571,494	2,171,599
Amounts outstanding in respect of warrants			–	(10,000)
			<u>11,571,494</u>	<u>2,161,599</u>

Stock options

The company has reserved 1,217,000 (1996 - 1,125,000) shares for issuance under stock option agreements with certain directors, officers and employees. The options expire after a maximum exercise period of three years from the date of issuance. The options outstanding at year-end were as follows:

	1997	1996
Balance – Beginning of year	900,000	500,000
Granted	917,000	500,000
Exercised	<u>(600,000)</u>	<u>(100,000)</u>
Balance – End of year	<u>1,217,000</u>	<u>900,000</u>

At December 31, 1997, the exercise prices of the outstanding options range from \$0.25 to \$0.60 (1996 - \$0.25 to \$0.40) per common share and expiry dates range from March 15, 1998 to December 22, 2000.

4. Income taxes

At December 31, 1997, the company had approximately \$1,789,000 (1996 - \$1,776,000) of tax pools available for deduction from future taxable income of which \$427,007 (1996 - \$427,007) are successor pools. In addition, the company has non-capital tax losses of approximately \$349,000 (1996 - \$349,000) the benefit of which has not been reflected in these financial statements due to a lack of virtual certainty of realizing the tax benefit.

Petro-Reef Resources Ltd.

Notes to Financial Statements

For the years ended December 31, 1997 and 1996

4. Income taxes (cont'd)

These losses expire as follows:

Expiry Date	Amount \$
1998	5,000
2000	24,000
2001	9,000
2002	163,000
2003	68,000
2004	80,000
	<u>349,000</u>

The income tax provision differs from the amount computed by applying the expected income tax rate of 44.62% (1996 - 44.58%) to earnings before taxes. The reasons for this difference are as follows:

	1997 \$	1996 \$
Loss before taxes	<u>(104,902)</u>	<u>(68,874)</u>
Effective tax rate	<u>44.62%</u>	<u>44.58%</u>
Expected tax recovery at combined federal and provincial rates	(46,807)	(30,717)
Crown royalties and production taxes	3,728	3,687
Alberta royalty tax credit	(2,287)	(2,707)
Crown lease rentals	(37,380)	(2,389)
Other	2,388	855
Benefit of losses not recognized	<u>80,358</u>	<u>31,271</u>
	<u>-</u>	<u>-</u>

5. Commitments

The present office lease agreement expires on August 31, 1998. Future lease payments over the next eight months under the company's office lease total \$4,545.

6. Related party

In 1997, companies controlled by two directors of the company each received \$25,000 (1996 - \$nil) as remuneration for their services. Prior to 1997, these directors had not been remunerated for their services since December 15, 1992.

7. Financial instruments

Financial instruments include cash and short-term investments, accounts receivable, and accounts payable and accrued charges. At December 31, 1997, the fair market value of the financial instruments approximated their carrying value due to the short-term maturity of these instruments.